OPINION AND JUDGMENT OF THE COURT OF APPEALS (Entered December 22, 1959).

"The above cause coming on to be heard upon the record, the briefs of the parties and the arguments of counsel in open court, and the court being duly advised;

"Now, therefore, it is ordered, adjudged and decreed that the judgment of the District Court be, and is hereby affirmed on the findings of fact and conclusions of law in the opinion of Judge Shelbourne, reported in 160 Fed. Supp. 631."

OPINION (MEMORANDUM) OF UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF KENTUCKY.

The two above styled and numbered actions were filed January 25, 1957, and, by an order dated July 17, 1957, they were consolidated and were tried together to the Court without a jury on September 11, 1957. They were submitted to the Court, following the filing of briefs, on January 2, 1958.

In action No. 3287, Wood-Mosaic Company (hereinafter referred to as "Company") seeks to recover corporation income and excess profits taxes paid for the fiscal years ended April 30, 1951, and April 30, 1952, in the aggregate sum of $152,926.43.

In action No. 3288, Wood-Mosaic Corporation (hereinafter referred to as "Corporation") seeks to recover corporation income taxes for the fiscal years ended April 30, 1952 and April 30, 1953, in the aggregate sum of $56,944.20. (Interest as provided by law is sought to be recovered by the plaintiff in each of the actions.)

By a written stipulation filed at the time of the trial, it appears that the Corporation was incorporated under

the laws of the State of Kentucky in 1907, under the corporate name "Wood-Mosaic Company." November 28, 1947, the corporate name was changed to "Wood-Mosaic Corporation." The Corporation has engaged in substantially the same business activities in the United States and Canada continuously from 1907 to the present date. The Company was incorporated under the laws of the State of Kentucky on November 28, 1947. Thereafter, on December 1, 1947, the Corporation transferred its operating assets and manufacturing facilities located in the United States to the Company and, in consideration of the transfer, received 177,810 shares of the common capital stock of the Company, which represented all of the outstanding and issued capital stock of the Company.

Both the Company and the Corporation kept their books and operated on the accrual basis of accounting and upon the basis of a fiscal year ending April 30th of each year; this fiscal year was used as the basis of their tax returns. The Corporation filed its corporation income and excess profits tax returns for each of the fiscal years ended April 30, 1951, and April 30, 1952, and paid the taxes disclosed to be due in each return . The Corporation likewise filed timely corporation income and excess profits tax returns for each of the fiscal years ended April 30, 1952, and April 30, 1953, and paid taxes disclosed to be due in each return.

March 29, 1956, the Commissioner of Internal Revenue notified the Company that a determination had been made of deficiencies in income and excess profits taxes for the fiscal year ended April 30, 1951, in the sum of $118,613.09, and for the fiscal year ended April 30, 1952, in the sum of $34,861.44.

March 29, 1956, the Commissioner of Internal Revenue notified the Corporation by letter that deficiencies had been determined in its income and excess profits taxes for the fiscal year ended April 30, 1952, in the sum of $20,640.15,

and for the fiscal year ended April 30, 1953, in the sum of $27,066.53.

The deficiencies and the interest thereon were paid by the Company and the Corporation to the District Director of Internal Revenue for the District of Kentucky. It is stipulated that both the Company and the Corporation timely filed their respective claims for a refund of the deficiencies in income and excess profits taxes and that, upon the claims for refund being officially disallowed and the separate claims for refund of interest having been ignored for more than six months by the Commissioner, these actions were timely filed.

The nine questions involved, as stated by counsel in their briefs, are substantially as follows:

1. Whether the Commissioner erred in disallowing a deduction of a loss in the sum of $3,366.29, claimed by Wood-Mosaic Company for the fiscal year 1951, under the provisions of Section 23(f) of the Internal Revenue Code of 1939, on account of the alleged abandonment of machinery and equipment in that year. (Taxpayer was allowed to amortize or depreciate the amount disallowed over the next succeeding five years.)

2. Whether the Commissioner erred in disallowing a deduction in the sum of $40,000.00 claimed by Wood-Mosaic Company for the fiscal year 1951, under the provisions of Section 23(q) of the Internal Revenue Code of 1939, as a charitable contribution to MacLean Foundation.

3. Whether the Commissioner erred in disallowing a deduction of a loss or a reduction in the value of its inventory in the sum of $12,112.84, claimed by Wood-Mosaic Company for the fiscal year 1952, on account of the alleged damage to a supply of Philippine logs purchased and loaded on board ship prior to the close of its fiscal year 1952, but not received in the damaged condition until the following fiscal year.

4. Whether the Commissioner erred in refusing to allow Wood-Mosaic Company a loss claimed on account of the reduction in the value of its inventory of Philippine mahogany lumber at the close of its fiscal year 1952, in the sum of $15,264.50.

5. Whether the Commissioner erred in disallowing deductions claimed by Wood-Mosaic Company of its inventory of supplies on hand at the close of the fiscal years 1951 and 1952, in the sum of $6,439.61 and $2,098.40, respectively, as a result of its change in the method of accounting for such supplies from an inventory method to the method of expensing them as purchases were made.

6. Whether the Commissioner erred in disallowing a loss claimed by Wood-Mosaic Company for each of the fiscal years 1951 and 1952 in the sum of $5,000.00, respectively, of the amounts by which the value of its inventory of walnut veneers was written down during each of these years.

7. Whether the Commissioner erred in disallowing a write-down by the Wood-Mosaic Corporation in the value of its inventory of forearm gunstocks as at the end of the fiscal year 1952 to the extent of $5,782.35.

8. Whether Wood-Mosaic Company, as an "acquiring corporation" within the meaning of Section 462(a) of the Internal Revenue Code of 1939, as amended by the Excess Profits Tax Act of 1950, may elect to compute its excess profits tax credits under Part I, Sub-chapter D of Chapter 1, 1939 Code, or whether it was required to compute its excess profits tax credits under Part II of that subchapter for the purpose of determining its excess profits tax for the taxable year 1951.

9. Whether Wood-Mosaic Corporation, as a "component corporation" within the meaning of Section 461(b) of the Internal Revenue Code of 1939, as amended, is entitled to or may elect to use its own base period experience prior

to the date of transfer of its assets to Wood-Mosaic Company on November 28, 1947, in computing its excess profits credits for the purpose of determining its excess profits tax for the taxable years involved.[1]

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Questions No. 8 and No. 9, which pertain to the excess profits tax claims of the Company and the Corporation, respectively, present a difficult problem. As stated by counsel for the Company and the Corporation, it is their contention that the Corporation was entitled to compute its excess profits tax credits by using its own base period experience under Section 435(d) of the Internal Revenue Code of 1939, and that, since the Company did not elect to combine its base period experience with that of the Corporation under Part II of the Excess Profits Tax Act of 1950, the Corporation was permitted to use its own base period experience for the general average of the base period years under Section 435(d). The contention is that, since the Company did not claim the right to use and did not use any of the base period experience of the Corporation, the Corporation could use its own base period experience prior to December 1, 1947, under Section 461 of the Internal Revenue Code of 1939, especially in view of the fact that the Company had not elected to use Part II in the computation of its own excess profits tax credit.

In Section 42.151, Volume 7A, Merten's Law of Federal Income Taxation, it is stated, "(T)ransfer of all or a part of the base period experience of a component corporation (Wood-Mosaic Corporation) to an acquiring corporation (Wood-Mosaic Company) as a result of a Part II transaction is accompanied by a reduction to that extent in the base period experience which remains available for use in respect to the component corporation." In a note to this portion

[1]NOTE: The part of the Court's Memorandum disposing of the factual issues not before the Court is omitted.

of the section, the author states, "The component loses the right to use the part of its base period experience made available to the acquiring corporation even though in fact the latter, where it has an option, may not choose to use it."

In computing its excess profits tax credits to determine its excess profits tax liability for the fiscal year 1951, the Company considered itself a "new corporation", under the provisions of Section 445, Part I, Subchapter D, Chapter 1, Internal Revenue Code of 1939. This produced a lesser amount of excess profits tax than would have been calculated under the provisions of Sections 435 and 436 of that subchapter.

The Commissioner determined that the Company was an acquiring corporation within the meaning of Section 461 (a) (1)(A), Part II, Subchapter D, and did not qualify as a new corporation within the meaning of Section 461(d). The Commissioner concluded that the Company was not entitled to compute its average base period income under the provisions of Section 435, Part I, because of the provision of Section 462(g)(3), "In the case of a transaction described in Section 461(a) where the acquiring corporation had commenced business, within the meaning of Section 461(d), prior to the beginning of its base period, the acquiring corporation shall not be entitled to compute its average base net income under Section 445 in the manner provided therein or as provided in this section." Therefore, the Commissioner recomputed the excess profits tax credit of the Company for the taxable year 1951 and the unused excess profits tax credit carry-back from the year 1952 to the year 1951, which materially reduced the amounts claimed by the Company in its returns for 1951 and 1952.

In computing its excess profits tax credit to determine its excess profits tax liability for the fiscal years 1952 and 1953, the Corporation used its own base period earning experience and applied the provisions of Section 435, Part I,

Subchapter D. It thereby determined that no excess profits tax was due by it.

The Commissioner properly determined that the Corporation was a component corporation within the meaning of Section 461(b), Part II, Subchapter D, and could not compute its excess profits tax credits under Section 435, but that same were required to be computed under Part II.

There is no question but that the Corporation is a component corporation and the Company is an acquiring corporation, since the Corporation, on December 1, 1947, transferred to the Company all of its operating assets and manufacturing facilities in exchange for all of the outstanding capital stock of the Company. In this situation, Section 461(b), Part II, Subchapter D, makes the Corporation a component corporation, and Section 461(a), Part II, classifies the Company as an acquiring corporation. Since the Company was an acquiring corporation within the meaning of Section 461(a) it is considered, under Section 461(d), to have been in existence and to have had taxable years for all years during which the Corporation was in existence and is considered to have commenced business when the Corporation commenced business.

We conclude that the Company erroneously classified itself as a "new corporation" under Section 445. The Company computed its excess profits tax credits under the provisions of Section 445, Part I; but, as above stated, as an acquiring corporation under Section 461(a), Part II, Subchapter D, it was ineligible as a new corporation under Section 445. Therefore, the Commissioners determination that the Company was required to determine its average base period net income under Part II of the Excess Profits Tax Act was correct, and the Company could not elect to compute its excess profits tax credits other than under Part II of Subchapter D.

The Corporation, in its excess profits tax returns for the fiscal years ended April 30, 1952, and April 30, 1953, computed its excess profits tax credits under the provisions of Section 435(d), Part I, on the basis of its own average base period net income. On its return for the fiscal year 1952, it claimed an unused excess profits tax credit carry-over from the fiscal year 1951 in a substantial amount and, on the return for the fiscal year 1953, it claimed unused excess profits tax credit carry-overs from the fiscal years 1951 and 1952 in an aggregate amount of $478,722.21.

The Commissioner determined that the Corporation was required to compute its excess profits credits as a component corporation under Section 461(b), Part II; that it was not entitled to use its own base period experience prior to the day after the date of the Part II transaction (December 1, 1947) in the computation of its excess profits credits, and that under no provision of the Excess Profits Tax Act of 1950 could the excess profits credits be computed to be in excess of the minimum annual amount of $25,000.00 prescribed in Section 431, Part II. This resulted in the excess profits credit for each of the fiscal years 1952 and 1953 being reduced to $25,000.00, and thereby eliminated any unused excess profits credit carry-overs from the fiscal years 1951 and 1952 to the fiscal year 1953, since the excess profits net income for the fiscal year 1951 was only $178.46 less than the minimum credit and exceeded the minimum credit for the fiscal years 1952 and 1953.

The issue raised as to the Corporation is whether it is mandatorily required to have its excess profits credit determined under Part II, or whether it may elect to have it determined under Part II or under the provisions of Section 435(d), Part I. It is our view that it was contemplated by Congress that, and Part II so provides, ownership of the property which gave rise to earning in the base period years must determine the entity which has the right

to this experience in the excess profits tax years; therefore, an acquiring corporation may use the base period earning experience of the component corporation prior to the Part II transaction, but the component corporation is prohibited from so doing. If the component corporation remains in existence, it loses any benefit it might otherwise have from its experience prior to the Part II transaction (December 1, 1947). We think the Commissioner was correct in his determination of the Corporation's method by which its excess profits tax must be determined.

The conclusion reached by the Court will be the basis of the judgment to be submitted by counsel for the United States, upon proper notice to counsel for plaintiff.

Roy M. Shelbourne
United States District Judge

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February 20, 1958.

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Title 26, Section 2—
Cross References

The cross references in this Chapter to other portions of the chapter, where the word "see" is used, are made only for convenience, and shall be given no legal effect.

TITLE 26—EXCESS PROFITS TAXES

PART I—RATE AND COMPUTATION OF TAX

Section 434. Excess profits credit—allowance

(*d*) *Domestic corporations.* In the case of a domestic corporation, the excess profits credit for any taxable year shall be an amount computed under section 435 or section 436, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed.

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Section 435. Excess profits credit—based on income

(*a*) *Amount of excess profits credit.* The excess profits credit for any taxable year, computed under this section, shall be—

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(*b*) *Base period.* As used in this subchapter the term "base period" means the period beginning January 1, 1946, and ending December 31, 1949, except that in the case of a taxpayer whose first taxable year under this subchapter was preceded by a taxable year which ended after December 31, 1949, and before April 1, 1950, and which began before January 1, 1950, the term "base period" means the period of 48 consecutive months ending with the close of such preceding taxable year.

(*c*) *Average base period net income—determination.* For the purposes of this section the average base period net income of the taxpayer shall be the amount determined under subsection (d), subject to the exception that if the taxpayer is entitled to the benefits of subsection (e) of this section, or section 442, 443, 444, 445 or 446, or any subsection of section 459, then the average base period net income shall be the amount determined under subsection (d)

or (e) or under such section or subsection, whichever results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed.

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Section 445. Average base period net income—new corporation

(*a*) *New corporation.* A taxpayer which commenced business after the first day of its base period shall, except as provided in subsection (g), be considered a new corporation for the purposes of this section, and its average base period net income determined under this section shall be the amount computed under subsection (b).

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(*g*) *Ineligible corporations.*

(1) If a taxpayer, on or after December 1, 1950, and prior to the end of its third taxable year, acquires any properties in any of the transactions described in paragraph (2), it shall not, for the taxable year in which such acquisition occurs or for succeeding taxable years, be entitled to the benefits of this section except under the circumstances and subject to the limitations provided in section 462(g).

(2) The transactions to which paragraph (1) applies are as follows:

(A) The acquisition by the taxpayer from another corporation of properties the basis of which in its hands is determined by reference to the basis of such properties to the transferor;

(B) The acquisition by the taxpayer of a substantial part of its assets from another corporation, or of a substantial part of the properties of another corporation, if 50 per centum or more in value of the outstanding stock or outstanding voting stock of the taxpayer is directly or indirectly owned, at the time of such acquisition, by in-

dividuals owning directly or indirectly 50 per centum or more in value of the outstanding stock, or outstanding voting stock of the transferor;

(C) The acquisition by the taxpayer of a substantial part of the properties distributed on or after December 1, 1950, by another corporation, if such properties constituted a substantial part of the business assets of such other corporation, and if 50 per centum or more in value of the outstanding stock or outstanding voting stock of the taxpayer is owned directly or indirectly by individuals who at the time of such distribution owned directly or indirectly 50 per centum or more in value of the outstanding stock or outstanding voting stock of such other corporation;

(3) For the purposes of this subsection, the provisions of section 503 shall be applicable in the determination of ownership of stock.

(*h*) *Cross references.*

(1) For definition of gross receipts, see section 435(e)(5).

(2) For computation of excess profits credit based on income in the case of certain reorganizations, see Part II of this subchapter. Added Jan. 3, 1951, 10:13 a.m., c. 1199, Title I, Section 101, 64 Stat. 1168, amended Oct. 20, 1951, 2:07 p. m., E. S. T., c. 521, Title V, Section 512, 65 Stat. 552.

PART II—EXCESS PROFITS CREDIT BASED ON INCOME IN CONNECTION WITH CERTAIN EXCHANGES

Section 461. Definitions

For the purposes of this Part—

(*a*) *Acquiring corporation.* The term "acquiring corporation" means—

(1) A corporation which has acquired—

(A) substantially all the properties of another corporation and the whole or a part of the consideration for the

transfer of such properties is the transfer to such other corporation of all the stock of all classes (except qualifying shares) of the corporation which has acquired such properties, or

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(*b*) *Component corporation.* The term "component corporation" means—

(1) In the case of a transaction described in subsection (a)(1), the corporation which transferred the assets;

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(d) [Existence of acquiring corporation.] For purposes of sections 435(e), 442, 443, 444, 445, and 446, any taxpayer which is an acquiring corporation shall be considered to have been in existence and to have had taxable years for any period during which it or any of its component corporations was in existence, and such corporation shall be considered to have commenced business on the earliest date on which it or any of its component corporations commenced business. Except for purposes of the previous sentence, a component corporation in a transaction described in subsection (a), other than one described in subsection (a)(1)(E), shall be deemed not to have been in existence or to have commenced business prior to the day after such transaction for purposes of determining the applicability of sections 435(e), 442, 443, 444, 445, and 446, to such corporation after such transaction. For purposes of the first sentence of this subsection, a corporation which was an acquiring corporation in a previous transaction shall be deemed to have been in existence for such period as is determined by the application of that sentence to that corporation with respect to that transaction. For purposes of this part, where sections 443(b), 444(c), 445(b), and 446(b) refer to the amount of a taxpayer's total assets as of the last day of its taxable year immediately

preceding the taxpayer's first taxable year under this subchapter, such references, where appropriate, shall be taken to mean the amount of such taxpayer's total assets as of the last day of its base period.

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Section 462. Average base period net income—determination

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(g) Use by acquiring corporation of alternative average base period net income provided for new corporations in section 445.

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(3) In the case of a transaction described in section 461(a) where the acquiring corporation had commenced business, within the meaning of section 461(d), prior to the beginning of its base period, the acquiring corporation shall not be entitled to compute its average base period net income under section 445 in the manner provided therein or as provided in this section. In any such case, however, where the acquiring corporation (other than a corporation created incident to the transaction) and all of the component corporations were, prior to the transactions, entitled to compute their average period net incomes under sections 442(d), 443, 444, 445, or 446, the acquiring corporation may add an average base period net income computed under section 445 of any of the parties to the transaction to such other average base period net incomes for the purpose of determining its average base period net income after the transaction under the section applicable to it prior to the transaction.

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